THE DRIVE YOU DEMAND

# INVESTOR INSIGHTS

## Eurozone

August 2017 | Global Investment Committee

UBP

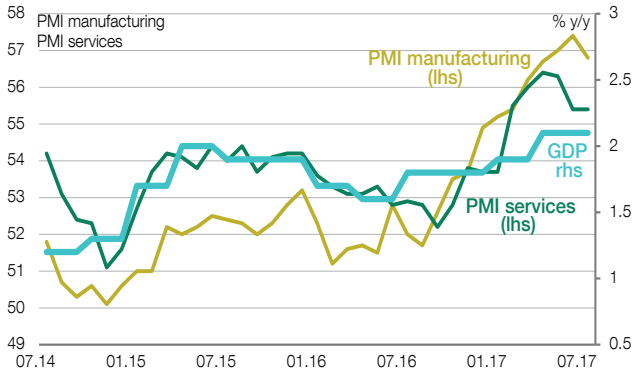
UNION BANCAIRE PRIVÉE

# EXECUTIVE SUMMARY

- The eurozone growth outlook has improved and it should benefit from sustained worldwide activity and a more supportive policy mix.
- Eurozone growth is expected to reach 2% in 2017 and stay close to 2% in 2018.
- Inflation will probably remain moderate, close to 1.5% y/y in the second part of this year; a progressive recovery is expected in 2018.
- The ECB is preparing financial markets for a progressive removal of its significant monetary support in 2018.
- Political risks have receded after the French elections. The forthcoming German elections are not a major issue for markets, as Chancellor Merkel stays ahead in the polls.
- A renewed European political project is expected after German elections thanks to a rejuvenated Franco-German political axis.
- The progressive shift in ECB strategy should generate upward pressure on European bond yields and add volatility to asset classes.
- We have moved back to overweight eurozone equities at the end of June with a tilt towards French equities and Small caps in EUR profiles.
- The prospect of reforms in France and, potentially, in the broader eurozone improves the medium-term outlook for corporate earnings. Within the eurozone, we continue to favour the banking sector, which still trades at reasonable valuations while being an attractive play on the domestic recovery.
- The EUR has strengthened on firmer growth and the prospect of a less accommodative ECB policy. Some retracement may be expected after this rebound.

**Positive momentum for eurozone GDP growth**

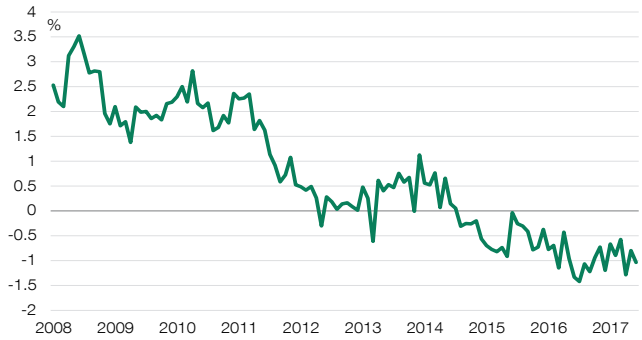
Eurozone: GDP & business confidence




Source(s): Markit, Eurostat

**Negative real interest rates have supported real activity, particularly in Germany**

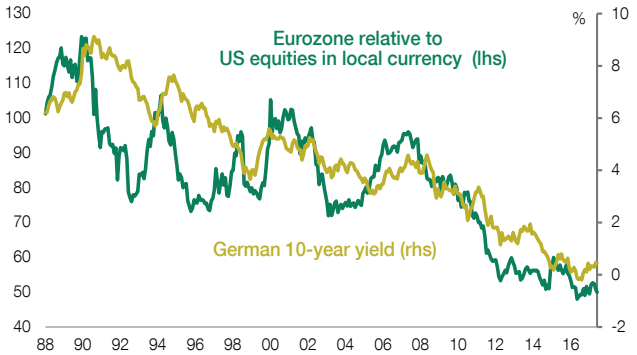
German real 10-year government bond yield (based on core inflation)




Source(s): Bloomberg Finance L.P., UBP

**Eurozone equities are also a play on rising yields**

Eurozone relative performance vs US equities & German 10-year yield



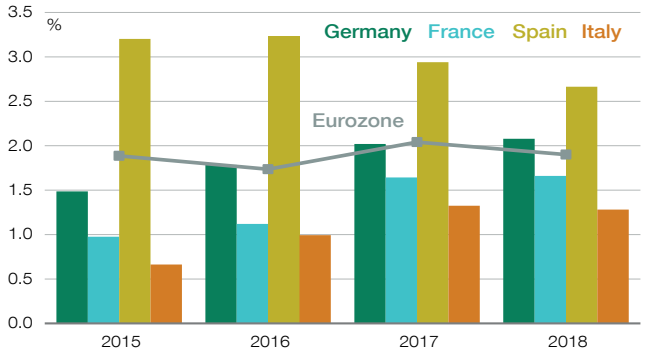

Source(s): MSCI, Thomson Reuters, UBP

# ECONOMIC OUTLOOK

- Growth is expected to reach 2% in 2017 and 1.9% in 2018, thanks to a firmer and broader recovery across member states. Leading indicators remain close to their highs.
- After French elections, political risks have receded and expectations of a renewed European political project have re-emerged.
- French government is expected to launch several reforms to increase the flexibility of the economy (labour, lower taxation and a reduced role for the State) and to push up its potential (to favour start-ups, capital risk and entrepreneurship).
- Given unclear prospects on UK Brexit, US trade policy and related performances of German exports, Chancellor Merkel looks ready to increase public spending, lower taxation and open discussion about some "federalism" in the eurozone after elections.
- European consumers should enter a positive economic cycle, as they will benefit from rising employment, easier fiscal policy and more moderate inflation.
- Capital spending is expected to continue to recover, following the rebound in business sentiment and firmer demand.
- Inflation has eased in Q2 on lower oil prices and higher EUR. Headline inflation is expected to stay around 1.5% in H2-17 and close to 1.5% on average in 2018, but monthly data should show a progressive recovery.
- The ECB is shifting its communications towards a less aggressive stance. In H2-17, it should announce the progressive end of its QE next year.

**A 2% growth trend expected in the eurozone**

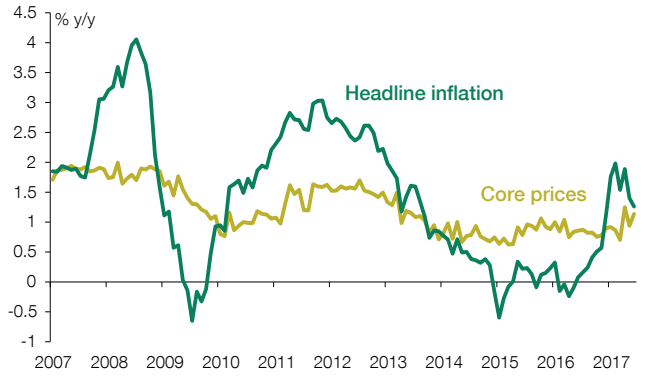
Eurozone GDP by country




Source(s): Eurostat, UBP

**Headline inflation to stabilise on moderate levels**

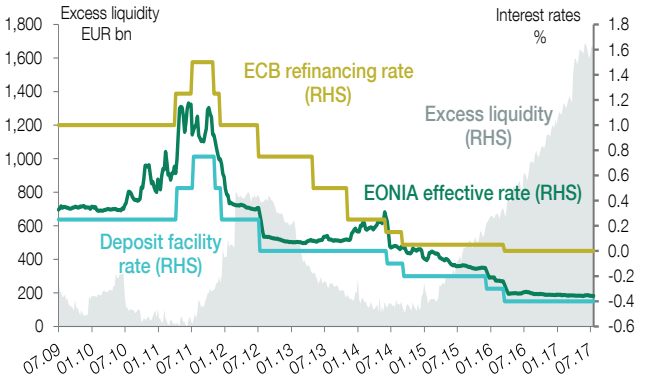
Inflation in the eurozone




Source(s): Eurostat

**Progressive end of QE expected in 2018**

ECB excess liquidity and interest rates



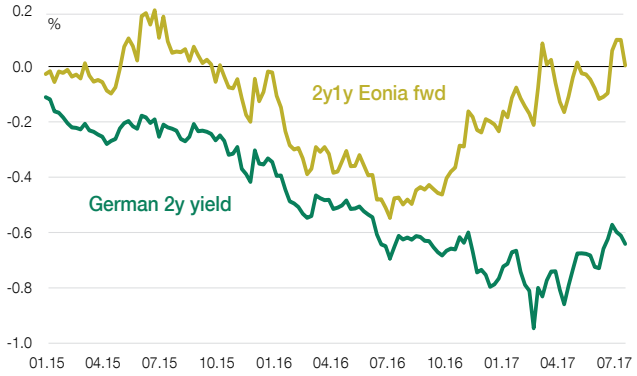

Source(s): Thomson Financial, UBP

# FIXED INCOME & FX OUTLOOK

- The ECB's QE has successfully restored a positive growth environment, but distorted European bond markets. German bond yields are definitely too low, compared to the current economic outlook.
- While the ECB should continue to support the economy in the short run, it will probably announce in H2-17 the progressive end of its QE next year. Low inflation delays any decision on interest rates.
- As the ECB shifts its communication towards a more neutral policy, we expect higher bond yields, and a more volatile environment. Real interest rates should rise from extreme negative levels, and yield curves are expected to steepen.
- We feel that spreads on EUR investment grade and EUR high yield inadequately compensate investors for the prospect of a rise in interest rate volatility. As a result, we maintain diversification in favour of non-directional bond strategies that can tactically capitalise on a shift in volatility.
- Within the fixed income universe, it seems to us that emerging market debt remains one of the few areas where investors are fairly compensated for both credit risk and the prospect of increased interest rate volatility.
- We believe that convertibles may offer some duration protection in a rising rate environment due to the equity optionality embedded in their structure.
- The EUR has strengthened on the prospect of firmer growth, the end of the ECB's QE and renewed confidence in European politics. Its recent rise could weigh on growth/ inflation outcomes and interfere with the ECB's scenario.

**A repricing of the ECB's scenario on bonds**

German 2y yield vs 2y1y Eonia fwd

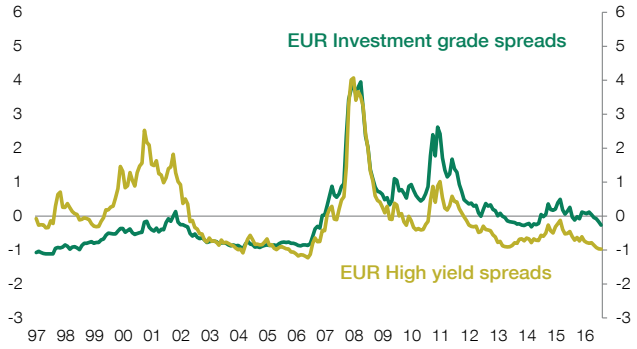



Source(s): BoA ML, UBP

**EUR Corporate bond spreads offer little cushion against rising rates**

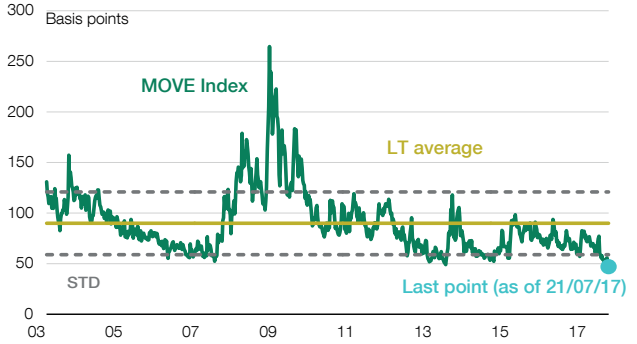
EUR investment-grade and high-yield corporate spreads

Standard deviation from long-term average (since 1998)




Source(s): BofAML

**Implied volatility of bond markets is expected to rebound from extremely low levels**



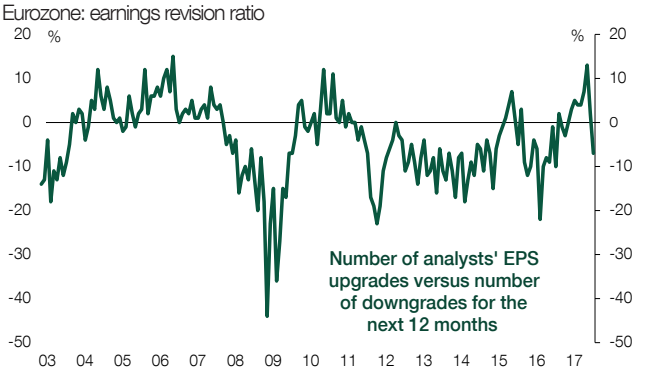

Source(s): Bloomberg Finance L.P.

# EQUITY OUTLOOK

- After several months of positive EPS revisions, earnings momentum weakened ahead of the Q2 reporting season, mainly on the back of the strengthening EUR.
- A stronger EUR will be an issue for eurozone exporters and domestic players should emerge as the relative winners. On the positive side, resilient EM currencies should help certain exporters.
- We have moved back to overweight eurozone equities at the end of June with a tilt toward French equities and Small caps in EUR profiles.
- The prospect of reforms in France and, potentially, in the broader eurozone improves the medium-term prospects for corporate earnings.
- Despite the scope for positive earnings surprises, eurozone equities trade at a significant discount to the US, even after adjusting for the difference in sector weightings.
- Within the eurozone, we continue to favour the banking sector, which still trades at reasonable valuations while being an attractive play on the domestic recovery. Credit continues to recover; the expected steepening of the yield curve should help net interest margins and the recent developments in Italy – on the political front and in the banking sector – have been reassuring.
- Our overweight stance is also justified by our view on bond yields; eurozone equities tend to outperform when long yields are on the rise.

**The appreciating EUR has recently weighed on earnings revisions…**

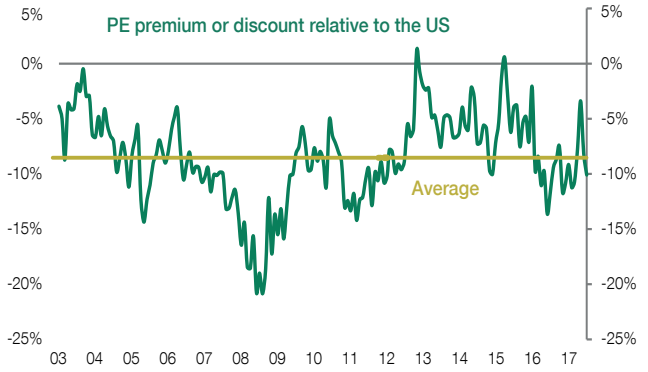
Eurozone: earnings revision ratio




Source(s): Thomson Financial

**… but the valuation gap with US equities has widened**

Europe sector-adjusted 12-month forward PE relative to the US




Source(s): Thomson Financial

**Eurozone banks would benefit from a steeper yield curve**

Relative performance of eurozone banks and EUR yield curve


Source(s): MSCI, UBP

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